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IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

No. 4.

FRANK M. McKEY, Trustee in Bankruptcy, *Petitioner*,

v.

MAURICE PARADISE, As Trustee, *Respondent*.

No. 5.

FRANK M. McKEY, Trustee in Bankruptcy, *Petitioner*,

v.

MAURICE PARADISE, As Trustee, *Respondent*.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

BRIEF FOR PETITIONER.

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BRIEF FOR PETITIONER FRANK M. McKEY, TRUSTEE IN BANKRUPTCY.

OPINIONS BELOW.

The opinion of the District Court has not been officially reported but is printed in full in the record (R. 17).

The opinion of the Circuit Court of Appeals (R. 29-37) is reported in 80 F. 2d 478.

JURISDICTION.

The date of the decree of the Circuit Court of Appeals for the Seventh Circuit (R. 37-38) sought to be reviewed was December 7, 1935.

The petition for writs of certiorari was filed March 4, 1936 and was granted April 6, 1936.

The jurisdiction of this court is invoked under Section 240 (a) of the Judicial Code as amended by the act of February 13, 1925. (28 U. S. C. A. Sec. 347 (a).)

STATUTES INVOLVED.

Bankruptcy Act, Section 64 (b), (11 U. S. C. A., Sec. 104):

> Sec. 104. *Debts Which Have Priority.* (b) The debts to have priority, except as herein provided, and to be paid in full out of bankrupt estates, and the order of payment shall be * * * (5) Wages due to workmen, clerks, traveling or city salesmen, or servants, which have been earned within three months before the date of the commencement of the proceedings, not to exceed $600.00 to each claimant.

Section 17 (11 U. S. C. A., Sec. 35):

> Sec. 35. *Debts Not Affected By a Discharge.* A discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such as * * * (5) are for wages due to workmen, clerks, traveling or city salesmen, or servants, which have been earned within three months before the date of the commencement of the proceedings in bankruptcy; or (6) are due for moneys of an employee received or retained by his employer to secure the faithful performance by such employee of the terms of a contract of employment.

Section 47 (11 U. S. C. A., Sec. 75):

> Sec. 75. *Duties of Trustees.* (a) Trustees shall respectively * * * (2) collect and reduce to money the property of estates for which they are trustees under the direction of the court, and close up the estate as expeditiously as is compatible with the best

interests of the parties in interest; and such trustees as to all property in the custody or coming into the custody of the bankruptcy court, shall be deemed vested with all of the rights, remedies and powers of a creditor holding a lien by legal or equitable proceeding thereon; * * *

STATEMENT.

The Grigsby-Grunow Company was adjudicated a bankrupt on March 13, 1934 and Frank M. McKey, the petitioner herein, was duly elected and qualified as trustee in bankruptcy on April 16, 1934, and the bankruptcy estate is now under liquidation.

On June 29, 1934 Maurice Paradise, as Trustee for approximately three thousand former employees of the Grigsby-Grunow Company, the respondent herein, filed in said bankruptcy proceeding a certain petition designated "Petition for Allowance of Preferred Claims" (R. 1-5) to which petition an answer was filed by Frank M. McKey, Trustee in Bankruptcy on July 27, 1934 (R. 6-10) which in substance denied that said claim was entitled to priority of payment within any of the provisions of the Bankruptcy Act.

On October 16, 1934 a stipulation of facts was entered into between the parties (R. 10-14) and filed in said bankruptcy proceeding.

Thereafter hearings were had before the Referee in Bankruptcy to whom the bankruptcy estate was generally referred and on December 14, 1934 said Referee entered an order allowing the said petition of Maurice Paradise, as Trustee and directing your petitioner to pay the said Maurice Paradise, as Trustee, the sum of $14,607.51 (R. 14-15).

A petition for review was filed with said Referee in Bankruptcy who certified the proceedings to the District Court, the Honorable John P. Barnes, District Judge presiding (R. 15-17) and thereafter proceedings were had

before said District Judge on said petition for review which resulted in an order being entered on March 28, 1935 reversing the order of the Referee and allowing the petition of Maurice Paradise, as Trustee, to stand as a general claim against the bankruptcy estate (R. 17-18) from which order two appeals were taken to the Circuit Court of Appeals for the Seventh Circuit, one as a matter of right, and the other with the consent of said Circuit Court of Appeals, which two appeals were later consolidated in said Circuit Court of Appeals by order of said Court (R. 27).

Thereafter on December 7, 1935 decrees were entered in said Circuit Court of Appeals reversing the decree of the District Court with directions to enter one in accordance with the views expressed in the opinion of said court (R. 37-38), the effect of which, if permitted to stand, would be to allow to Maurice Paradise, as Trustee, a prior claim in the sum of $14,607.51.

On April 6, 1936, this court granted the petition of Frank M. McKey, as trustee in bankruptcy for certiorari. (R. 38-39.)

While the facts have been stipulated to and appear at length in the record (R. 10-14) the following is a brief resume of the facts leading up to the controversy herein.

On February 4, 1933 and prior thereto, the Grigsby-Grunow Company maintained in connection with its business an unincorporated organization known as the "Majestic Employees' Welfare Association" which had been formerly known as the "Majestic Welfare and Athletic League". The Association's purpose was to provide life, health and accident insurance for the benefit of the employees of the bankrupt and their dependents. The Association was governed by its own officers and directorate and maintained its own account in The First National Bank of Chicago. The funds of the Association were invested exclusively in obligations of the United States Government and the earnings and increment of these invest-

ments were used for the insurance benefits contemplated by the Association's constitution and by-laws. The membership of the Association was comprised exclusively of employees who had been employed for thirty days or more and who had paid the initial fee of $1.00 to the treasury of the Association. The initial fee was automatically deducted by the Grigsby-Grunow Company from the amount due as salary or wages of each employee employed for the required period. In addition to the initial fee there were weekly dues of twenty-five cents per week which were likewise automatically deducted by the Grigsby-Grunow Company from the amount due each member as salary or wages. (R. 10-11)

Prior to February 4, 1933 the Grigsby-Grunow Company regularly paid the Association by check an amount equivalent to the accumulations of each payroll deduction, less deductions for expenses of the Association paid by the Grigsby-Grunow Company, which was deposited in the Association's treasury, and which check was charged to the Association's account on the books of the Grigsby-Grunow Company. (R. 11)

Commencing with February 4, 1933, however, the Grigsby-Grunow Company began to fall in arrears and from that time until November 24, 1933 when receivers in equity were appointed for the Grigsby-Grunow Company (who were later superseded by the receiver and trustee in bankruptcy) there was always a balance to the credit of the Association, which the Grigsby-Grunow Company had not paid to the Association. On November 24, 1933 said balance was in the sum of $14,607.51. (R. 11)

The deductions of twenty-five cents per week, including deduction for the initial fee, were made by charging the employees' account on the payroll records of the Grigsby-Grunow Company and crediting the aggregate of all such deductions to the account of the Majestic Employees' Welfare Association on the books of the Grigsby-Grunow Company. (R. 11)

No actual money was taken from the payroll envelopes of the employees and deposited in any account of the Grigsby-Grunow Company, but to the contrary the matter was handled as a mere bookkeeping entry, and at no time did the Grigsby-Grunow Company segregate any money due the Majestic Employees' Welfare Association or deposit any money in any separate trust account or bank account. (R. 11)

On November 24, 1933 the aggregate balances in all bank accounts of the bankrupt exceeded the amount claimed and at all times from February 4, 1933 to November 24, 1933 the total of daily balances of all the accounts exceeded the amount claimed. However, the general account of the bankrupt had during the period been reduced by withdrawals to a low point on September 23, 1933 to $4305.30 (R. 14).

On or about August 12, 1933 the Majestic Employees' Welfare Association was formally dissolved and disbanded and its assets were taken over by the Majestic Works Council, which like the Association, was an unincorporated organization in which the bankrupt and its employees had equal representation. (R. 11)

After the equity receivers had been appointed, but before these bankruptcy proceedings were instituted the Majestic Works Council disbanded, but before disbanding authorized Maurice Paradise to act as trustee for the employees to collect the amount alleged to be owing from the Grigsby-Grunow Company, and it was in this capacity that the claim was filed in these proceedings. (R. 12)

It was further stipulated that no part of the $14,607.51 claimed represented wages earned within three months before the date of the commencement of court proceedings (R. 28).

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

1. In holding that a trust relationship existed between the Grigsby-Grunow Company and the Majestic Employees' Welfare Association, or the successors of said Majestic Employees' Welfare Association.

2. In holding that the creation of an "indebtedness or liability to account" by mere bookkeeping entries such as the debiting of one set of accounts and the crediting of another account on the books of the bankrupt could be the subject of a trust or establish a trust fund which could be traced or identified.

3. In not following the federal rule of augmentation of assets as applied to estates of insolvents.

4. In holding that a mere "indebtedness or liability to account" could be the subject of conversion.

5. In holding in effect that where a constructive trust is created, i.e. a trust ex maleficio, that all of the property of the trust ex maleficio is charged with the claim of the cestui que trust.

6. In holding that the claim of Maurice Paradise, as Trustee was entitled to priority of payment.

7. In reversing the decree of the District Court.

SUMMARY OF ARGUMENT.

I.

The relationship of debtor and creditor between employer and employee, existing at the inception of the transactions in question, persisted throughout, notwithstanding the failure of the bankrupt company to carry out its promise to pay to the Welfare Association a sum equivalent to amounts charged against the employees, less deductions for the expenses of the Association paid by the bankrupt company.

II.

A transfer of accounts by mere bookkeeping entries, such as the debiting of a number of accounts and the crediting of another account without segregation of some specific or identifiable property does not create a fund which can be traced, or which can be said to augment the assets of an estate coming into the hands of a trustee in bankruptcy.

III.

The federal rule of augmentation of assets as applied to estates of insolvents should be extended to estates being liquidated under federal bankruptcy proceedings, since the theory of said type of proceedings is to secure an equal distribution of assets among all the creditors of the insolvent and to prevent preferences.

IV.

A mere "indebtedness or liability to account" cannot be the subject of trover or conversion since only tangible property can be the subject of conversion.

V.

The property coming into the hands of the trustee in bankruptcy is not charged with a general lien in favor of the claimant even though the bankrupt might be held to have been a trustee ex maleficio.

VI.

In bankruptcy proceedings, if a claim for priority of payment does not come within the provisions of Section 64B of the Bankruptcy Act, the claimant is not entitled to a prior claim unless he can establish that property belonging to him came into the estate and is traceable in the hands of the trustee in its original or substituted form.

VII.

Where the findings of a Referee are a deduction from established facts, or uncontradicted evidence, the Judge is at liberty to draw his own inferences and deduce his own conclusions.

ARGUMENT.

I.

The Relationship of Debtor and Creditor Between Employer and Employee, Existing at the Inception of the Transactions in Question Persisted Throughout, Notwithstanding the Failure of the Bankrupt Company to Carry Out Its Promise to Pay to the Welfare Association a Sum Equivalent to Amounts Charged Against the Employees, Less Deductions for the Expenses of the Association Paid by the Bankrupt Company.

Maurice Paradise, as Trustee, the respondent herein, appears as the representative of approximately three thousand former employees of the Grigsby-Grunow Company (R. 1-2). His rights, however, are not, strictly speaking, the rights of the individual employee, except to the extent of their joint and collective rights as members of the association, and to the extent that said former employees as members of the association are entitled to a pro rata distribution of the assets of the Majestic Employees' Welfare Association and its successor, the Majestic Works Council. (R. 3.) Maurice Paradise, as Trustee is, therefore, standing in the shoes of the Majestic Employees' Welfare Association, or its successor the Majestic Works Council, and is not, strictly speaking, standing in the shoes of the individual members of the Association or the Council. The relationship between the employees and the Grigsby-Grunow Company was that of debtor and creditor, the employees furnishing labor and other services to the Grigsby-Grunow Company for which the Grigsby-

Grunow Company, either expressly or impliedly, agreed to pay a stipulated amount for same. If the Grigsby-Grunow Company had failed to pay the amount due to the employees, the employees would have been relegated to an action at law on contract, and such failure of the Grigsby-Grunow Company could hardly be said to have amounted to a conversion and to subject the company to an action in trover.

The Majestic Employees' Welfare Association was an unincorporated society of the said employees whose affairs were governed by a board of directors and duly appointed officers of the employees' own choosing (R. 10). The method by which the Grigsby-Grunow Company became indebted to the Majestic Employees' Welfare Association was through a transfer on the books and records of the Grigsby-Grunow Company, i.e. by charging the employees' accounts on the payroll records with the amount of the weekly deductions of twenty-five cents and crediting the aggregate of all said amounts to the account of the Majestic Employees' Welfare Association (R. 11). No money was ever turned over or paid to the Grigsby-Grunow Company by its employees to be held by it for the benefit of the Majestic Employees' Welfare Association. The legal effect of this situation amounted to nothing more than a transfer of an account receivable due from the Grigsby-Grunow Company to its individual employees to an account receivable due from the Grigsby-Grunow Company to the employees jointly and collectively comprising the Majestic Employees' Welfare Association. In other words, merely an equitable assignment of a chose in action from the individual employee to the Majestic Employees' Welfare Association, and nothing more, and insofar as these bankruptcy proceedings are concerned, the account lost its right to priority of payment in bankruptcy by the expiration of the three-month period as fixed by Section 64 (b) 5 of the Bankruptcy Act. The failure of the Grigsby-Grunow Company to pay to the Welfare Association a sum

equal to amounts charged against the employees' accounts, less deductions for expenses of the Association paid by the bankrupt company was nothing more than a breach of contract for which the bankrupt company was liable at the suit of the Welfare Association in contract.

In the case of *Susan M. Bayor* v. *American Trust & Savings Bank,* Assignee, 157 Ill. 62-68, the Supreme Court of Illinois, on facts which are dissimilar to the case at bar, but which are in point by way of analogy as to the issue of law, held as follows:

> "Where the relation between the parties is primarily that of a debtor and creditor and there is a mere unperformed agreement on the part of the debtor to create a specific fund which shall possess a separate entity, and to hold the same in trust, it would be illogical and inconsistent with these adjudications to hold that such a creditor occupies a stronger position than one who is primarily the beneficiary of a distinct and identified trust fund."

The trust fund referred to in the above case is one created by an assignment of the debtor of its assets to the American Trust & Savings Bank for the benefit of its creditors.

It is to be noted that in the case of *Bayor* v. *American Trust & Savings Bank,* Assignee, supra, there was an agreement on the part of the debtor to create a specific fund which was to possess a separate identity, and to hold the same in trust. In the instant case there is nothing in the record of these proceedings to show that there was ever an express agreement to create a trust or that a specific fund was to be created possessing a separate identity, so that it appears that the Supreme Court of Illinois has gone much farther on this point than this court will be required to do under the existing state of facts.

In the case of *People* v. *Illiana State Bank,* 265 Ill. App. 29, the Appellate Court followed the decision of the Supreme Court of Illinois in the case of *Bayor* v. *American*

Trust & Savings Bank in holding that a trust relationship does not come into being by reason of a mere unperformed agreement where the relationship between the parties is primarily that of debtor and creditor.

In the case of *Colegrove & Co. Bank* v. *Gaupp,* 357 Ill. 499, the Supreme Court of Illinois held that to create a trust there must be a res in existence upon which the trust can act, and the mere execution and delivery of a declaration of trust is not sufficient to create a trust if, in fact, no res exists upon which it may operate.

It would, therefore, follow from the above that the relationship of debtor and creditor existing at the inception of the transactions in question persisted throughout and that the claim of the Majestic Employees' Welfare Association, and its successors, including that of Maurice Paradise, as Trustee is one based upon contract and, therefore, entitled only to participate in the Grigsby-Grunow Company bankruptcy estate as a general creditor.

II.

A Transfer of Accounts by Mere Bookkeeping Entries, Such as the Debiting of a Number of Accounts and the Crediting of Another Account Without Segregation of Some Specific or Identifiable Property Does Not Create a Fund Which Can be Traced, or Which Can be Said to Augment the Assets of an Estate Coming Into the Hands of a Trustee in Bankruptcy.

1. A transfer of accounts by mere bookkeeping entries, such as the debiting of a number of accounts and the crediting of other accounts, without segregation of some specific or identifiable property, does not create a fund which can be traced, or which can be said to augment the assets of an estate coming into the hands of a trustee in bankruptcy. The rule has thus been stated in *Brownell* v. *Turman,* 75 F. (2d) 913, 915:

"In order for appellee's claim to be allowed as a preference it was necessary to establish (1) that the funds claimed by him were impressed with a trust in his favor, (2) that there was an augmentation of the assets of the bank by virtue of the collection of his bonds, and (3) that the augmented assets have been traced into the hands of the receiver, and not merely into the general assets of the bank. See *Blakely* v. *Brinson*, 286 U. S. 254, 52 S. Ct. 516, 76 L. Ed. 1089, 82 A. L. R. 1288; *First National Bank* v. *City of Miami*, (C. C. A.) 69 F. (2d) 346; *Allied Mills* v. *Horton* (C. C. A.) 65 F. (2d) 708, 90 A. L. R. 1." (*Brownell* v. *Turman*, 75 F. (2d) 915.)

In the case of *Blakely* v. *Brinson* 286 U. S. 254-63 above referred to the relationship of debtor and creditor existed between a bank and its depositor on October 14, 1929 for the sum of $1961.31. The bank, through its officer, agreed to purchase $4000.00 of United States Bonds for the depositor and requested the depositor to deposit an additional $2100.00 to cover the cost of the United States Bonds. This the depositor did, thus increasing his deposit balance to $4061.31. The officer of the bank represented to the depositor that the bonds had been ordered and later advised him that the bonds had been purchased and handed to him a charge slip which stated that they were charging his account with $3964.60, being the purchase price of the United States bonds. The bank charged the depositor's savings account on its books with said sum and credited a like amount as a deposit in a bond account appearing on its books. When the bank closed its doors it was discovered that in fact no bonds had been purchased, ordered or received for the depositor. On these facts the District Court concluded that the bank had received the $3964.60 in trust for the purpose of purchasing the bonds, and that as the funds in the hands of the receiver had been augmented by the wrongful commingling of the trust funds with the other funds of the bank, the depositor was entitled to payment in preference to the general creditors

of the bank, the Circuit Court of Appeals affirming. The receiver of the bank took the position that no trust ever came into existence as the result of these transactions. This court, considering the effect of the bookkeeping entries, held as follows:

> "The cancellation of the credit balance by the debit neither suggests any intention to establish a trust nor points to any identifiable thing which could be the subject of it."

In the case of *Mechanics' & Metals National Bank of City of New York* v. *Buchanan,* 12 F. 2d 891 (CCA 8) a preferential claim against funds of the bank in the hands of a receiver was sought on the ground of a trust fund theory. In said case, as well as in the present instance, no payments in money were, in fact, made—the transactions being a mere bookkeeping transfer. Citing from page 892, the court held:

> "It is conceded that no payments in money were in fact made; therefore, the funds of the bank were not augmented in any way. The original notes were not taken up in whole or in part, but was left in the possession of appellant, which had no notice of the transaction prior to insolvency. A mere bookkeeping transfer was made which would have been effective perhaps if the bank had continued as a going concern, but by which the funds of the bank were in no respect augmented. It consisted merely of a shifting of credits on the books of the bank. The rule applicable is thus announced in *Beard* v. *Independent District of Pella City* (CCA 8) 88 F. 375, 31 C. C. A. 562.
>
> "It is indispensable to the maintenance by a cestui que trust of a claim to preferential payment by a receiver out of the proceeds of the estate of an insolvent that clear proof be made that the trust property or its proceeds went into a specific fund or into a specific identified piece of property which came to the hands of the receiver. The case made by appellant falls short of this requirement. Transactions upon which it relies consisted of a mere shifting of credits

> on the books of the insolvent bank. The assets of that bank were not increased thereby, nor were any funds set apart which, or any part of which, came into the hands of the receiver."

In the case of *Thompson* v. *Common School District,* 67 F. 2d 284 the Circuit Court of Appeals for the Ninth Circuit held that a bank's use of trust property or funds in such a way as merely to decrease its liabilities, as by using checks to pay its debts to other banks, does not augment assets in its receiver's hands as required to entitle beneficiary to priority.

To the same effect see *State Bank of Winfield* v. *Alva Security Bank,* 232 F. 847 (CCA 8), and *Beard* v. *Independent District of Pella City,* 88 F. 375 (CCA 8).

2. The federal courts have long followed the rule of "augmentation of assets" and have held that a transfer of accounts by mere bookkeeping entries, without actual segregation is not sufficient because it does not augment the assets of the estate and consists merely of a shifting of credits. The stipulation of facts clearly shows that there never was a trust fund; that no money passed between the employees and the Grigsby-Grunow Company so that there was nothing that ever existed which could be commingled or be the subject of a conversion.

In the case of *Edisto National Bank of Orangeburg* v. *Bryant,* 72 F. 2d 917-919 the Circuit Court of Appeals for the Fourth Circuit in an exhaustive opinion held as follows:

> "Trusts are not declared in vacuo because of a trust relationship. They must be predicated of particular property.
>
> (Citing Cases)
>
> And the record before us shows no property as to which a trust could have been predicated. The failure of the bank to segregate funds or set aside securities may have been a breach of legal duty on its part, but it certainly resulted in no identifiable res which could be declared the subject of a trust. As was well said by

Judge Sibley in *Wisdom* v. *Keen*, (CCA 5) 69 F. 2d 349-350 'Equity if dealing with the bank alone might well consider that it had done what it should have done and might well hold it to the consequences. * * * But in dealing with the distribution of the assets of an insolvent national bank and with the requirement of ratable dividends to all claimants, a more stringent adherence to what was actually done is proper. Here the bank agreed to segregate a trust res but never did it. By their mutual intent the bank's relation to Keen was that of a trustee rather than a debtor, but there is still no identifiable trust res traceable as such but only a liability for a breach of trust in failing to create the res.' As plaintiff has failed to show that the bank received in trust an identifiable res with respect to which a trust could be declared, it necessarily follows that it has failed to trace any such trust fund in the hands of the receiver or to show any augmentation of assets in his hands resulting from the conversion by the bank of such trust funds. This is fatal to the establishment of a trust against the assets in the hands of the receiver.

(Citing Cases)

The learned judge below was of the opinion that there had been a sufficient tracing of the funds under the rule laid down in *Schumacher* v. *Harriett*, 52 F. 2d 817 for the reason that it was admitted that the savings deposits of the bank at all times exceeded $19,000.00. But there can be no tracing of a trust fund where there was no trust fund in the first instance to trace, and even if there had been such a fund, the savings deposits of the bank which were liabilities and not assets would not assist in the tracing. Where a trust fund is shown to have been in existence and to have been converted by the bank, it may be segregated if it can be traced into an identifiable fund such as the cash of the bank; but here there could be nothing of that sort as no trust fund was shown to exist. When the bank qualified as executor, it was indebted to the estate of Bryant for the funds which had been deposited with it and there was no aumentation of its assets as a result of its qualification. At most there was a mere shifting of credits which could not serve

as a basis of a trust on the theory of augmentation." (Citing Cases)

In the case of *Santee Timber Corporation* v. *Ellott,* 70 F. 2d 179-183, the Circuit Court of Appeals for the Fourth Circuit held as follows:

> "Because of the importance of the question involved we have gone somewhat fully into the question as to the existence of a trust; but even if the bank were held a trustee of the funds covered by the deposits, complainant has not established any right to subject to the trust any of the assets which came into the hands of the receivers. As heretofore stated, the deposits in question were made by crediting to the Sales Agreement Account checks drawn by the hardware company against its general account in the bank. This resulted in a mere shifting of credits and added nothing to the bank's assets. There was consequently no augmentation of assets upon which a trust in favor of complaint could be predicated." (Citing Cases)

The Court's decision in *Santee Timber Corporation* v. *Elliott,* above quoted, was approved in *City Council of Charleston, S. C.* v. *Elliott,* 73 F. (2d) 920, 921, wherein the Court went so far as to hold that where the city had opened a special account with the bank for the payment of tax notes and the bank paid interest on the deposit balances but mingled the deposits with its other funds, there was no trust established even though the bank had asserted that the deposits constituted a trust fund and had promised but had failed to furnish security.

To the same effect is *State Bank of Winfield* v. *Alva Security Bank,* 232 F. 847, 849, quoted with approval in *Harry E. Jones, Inc.* v. *Kemp,* 74 F. (2d) 623, as follows:

> "The capital defect, however, of plaintiffs' theory is their treatment of the grand division of the bank's assets in its reports known as 'Cash and Sight Exchange 'as a fund' within the law relating to the following of trust funds. To adopt that theory is to re-establish under a mere bookkeeping disguise the

exploded notion that a trust fund may be recovered if it can be traced into the general assets of an insolvent estate. The courts have shown a tendency to restrict the 'trust fund' doctrine. *Empire State Surety Co.* v. *Carroll County,* 194 F. 593, 114 C. C. A. 435; *Board of Commissioners* v. *Strawn,* 157 F. 49, 84 C. C. A. 553, 15 L. R. A. (N. S.) 1100; *In re Brown* (C. C. A.) 193 F. 24; *Commercial National Bank* v. *Armstrong* (C. C.) 39 F. 684. The rule is accurately stated and numerous authorities cited by this court in the first case referred to, as follows:

" 'It is indispensable to the maintenance by a cestui que trust of a claim to preferential payment by a receiver out of the proceeds of the estate of an insolvent that clear proof be made that the trust property or its proceeds went into a specific fund or into a specific identified piece of property which came to the hands of the receiver.' " (*Harry E. Jones, Inc.* v. *Kemp,* 74 F. (2d) 627.)

In the case of *Swan* v. *Childrens Home Society of West Virginia,* 67 F. 2d 84-87 the Circuit Court of Appeals for the Fourth Circuit held as follows:

"But even if it be assumed that the bank is to be deemed a trustee of the fund covered by the deposit, plaintiff has not established any right to subject to the trust any of the assets which came into the hands of the receiver. It is conceded that no part of the fund has been traced into any specific investment or securities of the bank, and in addition to this it positively appears that no fund which has come into the hands of the receiver could have been augmented as a result of the deposit here in question. As heretofore shown, this deposit was made by the administrator giving the bank a check on his deposit account. This account was not a trust fund held by the bank, but an ordinary deposit account evidencing an indebtedness of the bank which upon insolvency would have stood upon the same basis as other deposits.

(Citing Cases)

And the check to the bank resulted in a mere shifting of credits and added nothing whatever to its assets.

There was consequently no augmentation of assets upon which a trust could be predicated." (Citing Cases)

These propositions of law if standing alone are sufficient to afford the basis of denying priority to the claim of Maurice Paradise, as Trustee. It has always been the rule in the federal courts that before a prior claim can be allowed against the assets of an insolvent, the funds coming into the hands of the receiver or trustee must have been augmented by funds or property of the claimant, and that a transfer effected by mere bookkeeping entries, does not augment the assets of the estate. The court below in its decision in this case entirely ignored the question with respect to the requirement of the augmentation of assets rule, although this point was raised both in the briefs filed and in the oral argument before the court so that the question was properly before the court.

III.

The Federal Rule of "Augmentation of Assets" as Applied to Estates of Insolvents Should be Extended to Estates Being Liquidated Under Federal Bankruptcy Proceedings, Since the Theory of Said Type of Proceedings is to Secure an Equal Distribution of Assets Among All the Creditors of the Insolvent and to Prevent Preferences.

The Circuit Court of Appeals in its decision in this case seeks to distinguish this case from the cases cited on the ground that in the cases cited by your petitioner, the parties sought to be held as trustee were national banks, and that the national bank statutes and the regulations of the national bank department governing the liquidation of insolvent banks are confirmatory of the relationship of debtor and creditor between depositor and bank.

It is respectfully urged that the Circuit Court of Appeals has overlooked the fact that the Bankruptcy Act is

an exercise of the constitutional authority of Congress to the same extent as the National Banking Acts and that the purpose of both the National Banking Act and the Uniform Bankruptcy Act is primarily to secure an equal distribution of assets among all of the creditors of the insolvent and to prevent preferences.

In the case of *Stratton* v. *New*, 283 U. S. 318-320, this court speaking through Justice Roberts held as follows:

> "The purpose of the bankruptcy law passed pursuant to the power of Congress to establish a uniform system of bankruptcy through the United States was to place the property of the bankrupt, wherever found, under the control of the court for equal distribution among the creditors."

In the case of *Wood* v. *A. Wilbert's Sons Shingle & Lumber Co.*, 226-234 U. S. 324, this court speaking through Justice McKenna held as follows:

> "The Bankruptcy Act is very comprehensive of the whole subject of bankruptcy. It creates courts of bankruptcy and is full in its provisions for the collection and preservation of the estate of the bankrupt through trustees appointed by creditors, who are given power to bring suits to recover the property of the bankrupt which has been conveyed by him in fraud of his creditors, or to give a preference to any of them; the purpose of the Act being to secure an equality of distribution of the assets of the bankrupt among his creditors."

To the same effect see:

Clark v. *Rogers*, 228 U. S. 534;
Pirie v. *Chicago Title & Trust Co.*, 45 L. Ed. 1171;
Boese v. *King*, 108 U. S. 379.

This court has also held that the primary purpose of the National Banking Act is to secure an equal distribution of assets among all of the creditors of the insolvent and to prevent preferences.

In the case of *Jennings* v. *United States Fidelity & Guaranty Company,* 294 U. S. 216-226; the court held as follows:

> "As applied to a national bank, the preference is plainly inconsistent with the system of equal distribution established by the Federal Law."

In the case of *Adams* v. *Champion,* 94 U. S. 231-239, the court held as follows:

> "The assets of the bank were now held by the receiver upon a trust for equal distribution."

It, therefore, appears from the above cited cases that the purpose of the Uniform Bankruptcy Act and the National Banking Act is identical and that the cases under the National Banking Act should be applicable to cases under the Uniform Bankruptcy Act. If so the frequently reiterated rule should be applied as stated in *Atlantic Gypsum Co.* v. *Federal National Bank of Boston,* 76 F. (2d) 59, 61;

> "The liquidation of national banks is controlled by statute; and the statute is distinctly unfriendly to the recognition of special interests or preferred claims. R. S. Sec. 5236 (12 USCA Sec. 194); *Cook County Nat. Bank* v. *U. S.,* 107 U. S. 445, 450, 2 S. Ct. 561, 27 L. Ed. 537. Doubts should be resolved against them. *Blakely* v. *Brinson,* 286 U. S. 254, 52 S. Ct. 516, 76 L. Ed. 1089, 82 A. L. R. 1288; *Texas & Pacific Ry. Co.* v. *Pottorff,* 291 U. S. 245, 54 S. Ct. 416, 78 L. Ed. 777; *First National Bank* v. *Miami,* (C. C. A.) 69 F. (2d) 346, 349." (*Atlantic Gypsum Co.* v. *Federal Nat. Bank of Boston.* 76 F. (2d) 61.)

IV.

A Mere "Indebtedness or Liability to Account" Cannot be the Subject of Trover or Conversion Since Only Tangible Property Can be the Subject of Conversion.

The court below in this case appears to have predicated its decision on the theory that the bankrupt was guilty of conversion of property of its employees and, therefore, stood in the position of a trustee ex maleficio. It speaks of "money" deducted from the wages of the employees, and "funds" and "dollars" which the bankrupt failed to turn over to the Welfare Association, while in fact no actual money was involved. Quoting from the decision rendered (R. 32):

> "Instead of turning over to the welfare association the money deducted from the employees' wages, the bankrupt converted it to its own use. It credited itself with the payment of the amount and yet retained the said sum in its own treasury. This was a conversion."

Again—(R. 33):

> "What bankrupt did was to take the money, the amount of which was the unpaid wages of its employees, from one pocket and transfer the same money to another pocket, and to announce in legal effect, that in this sum it was now indebted to the welfare association. It should have paid it to the association. It was guilty of conversion when it did not do so."

Again—(R. 33):

> "Such a trust so created (a constructive trust, a trust ex maleficio) will not fall though other dollars may take the place of the original ones received when the employees made their contribution to the fund."

Again—(R. 35):

> "Such a trust, equity will follow even though there has been a commingling of the trust fund with private accounts."

No coin or other specie of money is involved in the transaction in question. The employees performed labor and services for which they were entitled to compensation, for the payment of which the Grigsby-Grunow Company was legally liable. Up to the time of actual payment, no coin or other specie of money was involved. The bank accounts of the Grigsby-Grunow Company represented merely an obligation on the part of the respective banks to pay a given amount to the Grigsby-Grunow Company on demand and a relationship between the Grigsby-Grunow Company and its banks was clearly one of debtor and creditor. In the absence of money, i.e. actual coin or specie, there was nothing that the Grigsby-Grunow Company could convert, or which could be the subject of conversion. The following text quotations are illustrative of the true principles involved:

> "The general principle must, however, not be ignored that trover lies for the conversion of money only when there is an obligation resting on the defendant not to convert to his own use specific coin or notes."
>
> 26 RCL 1102, Note 8.
>
> "Trover will not lie for a general debt."
>
> 50 ALR 1171.
>
> "Only tangible property is subject to conversion."
>
> Cooley on Torts—4th Edition, Volume 2, page 498.

While in the instant case there is nothing of a tangible nature which could be the subject of conversion, it is also true that money is the subject of conversion only where there is an obligation on the part of the recipient to return the specific money entrusted in his care.

> "Hence, trover will not lie for money delivered to one person to be expended in behalf of another and by the former converted to his own use."
>
> 26 RCL 1102—Note 9.

> "Trover will not lie for money which was given to the defendant to be used for a particular purpose and which the defendant converts to his own use."
> Cooley on Torts, 4th Edition, Volume 2, Section 330, page 496.

In the case of *Shrimpton & Sons* v. *Culver,* 109 Mich. 577 67 NW 907, The Supreme Court of Michigan, held as follows:

> "Trover is not maintainable for money unless there be an obligation on the part of the defendant to return the specific money entrusted in his care."

In the case of *Larson* v. *Dawson,* 24 RI 317, 53 ATL 93; 96 Am. St. Rep. 716, the Supreme Court of Connecticut held that trover for conversion of money will not lie where there was no duty resting on defendant to keep the money intact in specie.

In the case of *Rothschild* v. *Schwarz,* 59 NYS 527-528 the Supreme Court of New York held as follows:

> "Conversion has reference to specific articles of property which are owned by plaintiff, or to which he has the right of immediate possession. It does not apply to money when the receipt of it creates only a debt to the plaintiff as in the case at bar. An action for conversion cannot be maintained against a person who receives money in a fiduciary capacity unless he is bound to turn over the identical money."

In the case of *Kovusch* v. *Lowenberg,* 185 SW 747-748 the St. Louis Circuit Court of Appeals held as follows:

> "Money is the subject of conversion only when it can be described or identified; as a specific chattel."

To the same effect see:

> *Anderson Electric Car Co.* v. *Savings Trust Co.* 212 SW 60.

In the case of *Kerwin* v. *Thomas J. Balhatchett,* 147 Ill. App. 561-565 money was voluntarily given to the defendant

to do certain things with—to pay himself the debt which plaintiff owed him and then to discharge other specified indebtedness of plaintiff and to account to her for the balance. Suit was instituted against the defendant in trovel for conversion and judgment was rendered for the plaintiff. The Appellate Court in reversing and setting aside the judgment says as follows:

> "The relation of debtor and creditor was thus created between them. Trover lies for specific chattels wrongfully converted and not for money had and received for payment of debts. It does not operate on chattels generally but specifically such as money in coin or bills, animals or other property capable of identification as being the actual property or thing wrongfully taken and converted."

The court below cited the following from *Jennings* v. *U. S. F. & G. Co.*, 294 U. S. 216-224: (R. 33)

> "Dollars are fungibles and any one of them will be accepted as a substitute for another."

No fault can be found with this doctrine. However, in speaking of dollars as being fungibles, this court was referring to a situation where actual dollars were received and commingled with other dollars. Preceding the above quotation was the following:

> "Currency paid over the counter and deposited in a vault is a thing that can be identified and so subjected to a trust whenever in equity and conscience a trust should be implied. Not only that, but a trust so created will not fail though other dollars may have taken the place of those originally received, for dollars are fungibles and any one of them will be accepted as a substitute for another."

This court in the same case pointed out the distinction between a situation where actual dollars are received and commingled, and where nothing has been received which could be commingled. Reading from the opinion, page 224:

"But the situation is very different when what has been received by the collecting agent is not a thing at all but a reduction of liabilities by set-off or release.

(Citing Cases)

"A debt does not furnish a continuum upon which a trust can be imposed after cancellation or extinguishment has put the debt out of existence."

It is respectfully urged that the Circuit Court of Appeals misconceived both the nature of the transaction in the instant case and the doctrine of trover and conversion, and that in holding that the Grigsby-Grunow Company was a trustee ex maleficio because of said alleged conversion plainly erred.

V.

The Property Coming Into the Hands of a Trustee in Bankruptcy is not Charged With a General Lien in Favor of the Claimant Even Though the Bankrupt Might be Held to Have Been a Trustee Ex Maleficio.

The decision of the court below in effect holds that where a constructive trust is created, i.e. a trust ex maleficio, all of the property of the trustee is charged with the claim of the cestui que. This theory is against the weight of authority as will appear from an examination of *St. Louis & S. F. R. Co.* v. *Spiller,* 274 U. S. 304-309. In said case a railroad company had exacted illegal freight rates, which it was subsequently ordered to repay to the shipper. The Court of Appeals held that the railroad company became liable as trustee ex maleficio for the overcharges and that this liability was enforceable as upon a constructive trust; the only claim made that the money collected could be traced into the hands of the receiver was that throughout the ten years which elapsed between the earliest exaction and the transfer of properties to the new company, the old one and the receiver had at all times in the several banks on which checks for various expenses were drawn, a working balance

in the aggregate largely in excess of the shipper's claim. This court in passing upon said contention, in its opinion on pages 309 and 310 held as follows:

> "The assertion that the money collected can be traced into the receivers hands is confessedly without any support except the stipulated fact that throughout the ten years which elapsed between the earliest exaction and the transfer of the properties to the new company, the old one and the receiver had at all times in the several banks on which checks for current expenses were drawn, a working balance in the aggregate, largely in excess of Spiller's claim. Such a showing fails to bring the present case within the rule by which, when trust funds are mingled with others, the cestui may assert an equitable lien upon the mingled mass to the extent of his contribution thereto."
>
> (Citing Cases)
>
> "An illegal exaction does not impress an indelible trust upon all funds which the wrong-doer and his successors may thereafter have on deposit in their banks. For aught that appears all the money illegally exacted may have been spent for current operating expenses."

In the case of *Spokane County* v. *First National Bank of Spokane,* 68 F. 979 (CCA 9) the court held: (quoting from syllabus)

> "The owner of property entrusted to another by whom it has been misapplied is not entitled to a general lien upon the assets of the trustee for the value of such property, but can only follow the same so far as it can be traced, either in its original form or in other forms into which it has been converted."

In the case of *Burgoyne* v. *McKillip,* 182 F. 452-454 (CCA 8) (Cert. denied 55 L. Ed. 605) the court held as follows:

> "Although a demand may be founded on a breach of trust, the entire estate of the recreant trustee is not thereby necessarily impressed with a trust."

In the case of *Samuel Little and Others* v. *Joseph H., Chadwick and Others*, 151 Mass. 109-110, the court held:

> "When trust money becomes so mixed up with the trustee's individual funds that it is impossible to trace and identify it as entering into some specific property, the trust ceases. The court will go as far as it can in thus tracing and following the trust money but when as a matter of fact it cannot be traced, the equitable right of the cestui que trust to follow it fails. Under said circumstances, if the trustee has become bankrupt, the court cannot say that the trust money is to be found somewhere in the general estate of the trustee and still remains. He may have lost it with property of his own and in such case the cestui que can only come in and share with the general creditors."

In the case of *Worchester Bank & Trust Co., Trustee* v. *Robert A. Nordblom,* 285 Mass. 22-25, the court held as follows:

> "Apart from statute, in the distribution of the assets of an insolvent or deceased trustee, a claim based on the duty of the trustee or its breach is entitled to no priority because of its origin. Inherently a claim upon a grocery bill or promissory note ranks as high. It is only where some of the assets can be shown to be a part of the trust estate, or the product of the conversion of specific funds, or property of the trust estate into another form, that the trust estate can obtain an advantage over the creditors generally. That advantage is not a right to priority or preference but rather a right to reclaim assets of the trust estate that can be traced and found."

In the case of *Macy* v. *Roedenbeck,* 227 F. 346-352 (CCA 8) the Circuit Court of Appeals for the Eighth Circuit held as follows:

> "The ownership of this note and the fact that Roedenbeck was the owner of the proceeds of its collection, after the proceeds had been misapplied by the Bank of Sully to whom it had been entrusted, did not entitle Roedenbeck to a general lien upon the assets of the

> trustee in bankruptcy of such bank for the value of such property. He can only follow the note or the proceeds of the collection so far as it can be traced in its original form or in other forms into which it has been converted."

In the case of *Zenor* v. *McFarlin*, 238 F. 721 (CCA 8) the Circuit Court of Appeals for the Eighth Circuit held as following (reading from the syllabus):

> "One who delivered grain to a warehouseman, who subsequently became bankrupt after selling the grain is not entitled to a preference for the value of the grain, unless there is clear proof that the proceeds of the sale went into a specific fund or into specifically identified property, which came into the hands of the trustee in bankruptcy, it not being sufficient that it went into the general assets of the bankrupt and thereby increased his estate."

In the case of *In re Morris Brothers, Inc.*, 293 F. 294-296 (CCA 9) the Circuit Court of Appeals for the Ninth Circuit held as follows (reading from the syllabus):

> "One who as a result of fraud paid money to bankrupt corporaton which went into its general funds and was used in its business and cannot be traced into any property in the hands of its trustee, cannot establish a trust which entitles him to preference over general creditors."

We have shown by the above cited cases that even if the Grigsby-Grunow Company is held to be a trustee ex maleficio that it would not necessarily follow that Maurice Paradise, as Trustee was entitled to priority of payment in these bankruptcy proceedings since there never was a trust fund or res which could be the subject of a trust. The law is clear that the mere fact that the insolvent was a trustee ex maleficio does not create a general lien upon all of its assets or a lien upon its bank accounts where such lien is sought to be enforced against assets coming into the hands of a trustee in bankruptcy for the benefit of all creditors.

VI.

In Bankruptcy Proceedings, if a Claim for Priority of Payment Does not Come Within the Provisions of Section 64(B) of the Bankruptcy Act, the Claimant is not Entitled to a Prior Claim Unless he can Establish That Property Belonging to Him Came Into the Estate and is Traceable in the Hands of the Trustee in its Original or Substituted Form.

1. The law is well settled that even assuming a trust fund actually existed, before it can be followed and recovered in bankruptcy proceedings, it must be clearly traced and identified in some specific fund or property coming into the hands of the trustee in bankruptcy, and that the burden of proof in tracing said fund rests upon the claimant thereto. These principles have been upheld in the following cases involving bankruptcy proceedings:

In the matter of *J. Albert See, Bankrupt*, 209 F. 172 (CCA 2)
In re *McIntyre & Co.*, 185 F. 96 (CCA 2)
In re *Newark Shoe Stores, Inc.*, 3 Fed. Sup. 293 D. C. Md.

In the case of *J. Albert See, Bankrupt*, 209 F. 172-174 (CCA 2) the Circuit Court of Appeals for the Second Circuit held as follows:

> "It is well known that there are some conflicts of authority upon the question as to whether a trust fund can be followed only when the specific subject matter can be clearly traced or identified or whether it will be sufficient if it can be shown that it has found its way into the assets although it cannot be identified in any particular fund or property. The better doctrine, and that sustained by weight of authority, is that a trust fund can be followed and recovered in bankruptcy only when it can be clearly traced and identified in some specific fund or property coming into the hands of a receiver or trustee in bankruptcy."

In the case of *In re McIntyre & Co.*, 185 F. 96 the doctrine of following trust funds is discussed and the Circuit Court of Appeals for the 2nd Circuit made the following comment:

> "While the doctrine of following trust funds has been much extended in the modern decisions there has never been a departure in the Federal courts from the principle that there must be some identification of the property sought to be charged with the trust funds."

In the case of *Newark Shoe Stores, Inc.*, 3 Fed. Sup. 293-295 approximately three hundred employees of the Newark Shoe Stores, Inc., Bankrupt, filed prior claims in said bankruptcy proceedings based upon deposits of $200.00 which each of said employees had made with the bankrupt as security for the faithful performance of their duties, and which amount was to be returned to them upon termination of their employment. These deposits were collected over a period of fifteen years and were commingled with other deposits of the bankrupt. At no time were the aggregate balances of the combined bank accounts of the bankrupt less than approximately $68,000.00, more than enough to discharge the amount of said deposit claims. The employees contended that they were entitled to priority on either of two grounds—first, that the deposits were in the nature of trust funds to which the bankrupt company does not obtain any beneficial title and—second, that the deposits were entitled to priority upon general equitable principles. The court held that the deposits were in the nature of trust funds, although not entitled to priority on so-called general equitable principles, but further held it would not necessarily follow that all or any of the deposits should be refunded. Quoting from the decision:

> "No deposit can be, unless at the present time, it is definitely traceable into one of the company's bank accounts, and only if it can be shown that such bank account has never been less than the amount of such de-

posit and that the funds in that account have come into the hands of the trustee in these bankruptcy proceedings."

(Citing Cases)

"The apparent hardship of the rule herein announced is regrettable, but courts may not, without warrant, extend the clearly defined limitations of the Bankruptcy Act and create preferred creditors, in derogation of the rights of general creditors."

This decision was decided on authority of *St. Louis & S. F. R. Co.* v. *Spiller,* 274 U. S. 304-309.

In the case of *Schuyler* v. *Littlefield, Trustee,* 232 U. S. 707-710 the Supreme Court laid down the following propositions:

"Where one has deposited trust funds in his individual bank account and the mingled fund is at any time wholly depleted, the trust fund is thereby dissipated and cannot be treated as reappearing in sums subsequently deposited to the credit of the same account.

One seeking to charge a fund in the hands of a trustee for the benefit of all creditors as being the proceeds of his property and, therefore, a special trust for him, has the burden of proof and if he is unable to identify the fund as representing the proceeds of his property, his claim must fail as all doubt must be resolved in favor of the trustee who represents all creditors."

These principles also find support in the decision of the court in the case of *St. Louis & S. F. R. Co.* v. *Spiller,* 274 U. S. 304-309, and in the following cases.

In the case of *Colegrove & Co. Bank* v. *Gaupp,* 357 Ill. 499-505 the Supreme Court of Illinois in October 1934 held as follows:

"The right to reclaim a trust fund is founded on the right of the ownership of the fund on the part of the party claiming the same to have it restored to him by the party having possession of the fund. Such claim

is not based upon the relationship of debtor and creditor or tort feasor, but is bottomed solely on ownership. Therefore, to recover as a cestui que, the owner or beneficiary of the trust property must prove that the alleged trustee has, in fact, the property even though it be in an altered form. Failing in this the trust fails, and the claims, if there is any legal liability therefor, becomes merely one of compensation on the same plane as other general debts."

In the case of *Harmer* v. *Rendelman*, 64 F. 2d 422-423, the question as to the tracing of trust funds was fully considered by the Circuit Court of Appeals for the 4th Circuit, the court holding as follows:

"The old rule with regard to the tracing of trust funds wrongfully misapplied, or the proceeds or property wrongfully converted, was that the right ceased when the property was turned into money and mixed and confounded in the general mass of property of the same description."

(Citing Cases)

"The modern rule, however, is that where such property or proceeds has gone to swell the aggregate in the possession of the fraudulent party, it may under proper proceedings, be segregated in amount from such aggregate sum, and made the subject of a trust, in order to accomplish the ends of justice."

(Citing Cases)

"But there is a limitation upon this modern rule as well setlled as the rule itself, viz; that it is not sufficient to prove merely that the trust property has gone into the general estate and has presumably increased its amount and value. It is indispensable that clear proof be made that the trust property or its proceeds has gone into a specific fund or into a specific identified piece of property, or has directly augmented a fund upon which the trust is to be declared. When it is sought to impress funds in the hands of a receiver with a trust on account of the wrongful conversion of trust property by an individual or corporation to whose rights he has succeeded, it must be shown that the funds in his hands have been directly augmented by

the presence of the trust property or its proceeds, so that a court of equity can see with certainty that the trust property is in his hands."

In the case of *Hanna* v. *Consolidated School District No. 1*, 78 F. 2d 374-377 (CCA 8), the Circuit Court of Appeals for the Eighth Circuit held as follows:

"The diligence of counsel has not disclosed any case in the Eighth Circuit where this court has deviated from its invariable rule that the claimed trust fund must be clearly proven to have gone into the fund in the receiver's hands before preference will be awarded. We think it equally clear that in so adhering this court has conformed to the mandate of the Supreme Court decisions."

(Citing Cases)

In the case of *Swan* v. *Childrens Home Society of West Virginia*, 67 F. 2d 84-88 the Circuit Court of Appeals for the Fourth Circuit held as follows:

"It is the contention of plaintiff that where a trust relationship is established, no augmentation or tracing need be shown, but that because of relationship, the cestui que trust is given preferential status in the distribution of the assets in the hands of the receiver. We do not concede this to be the law. The policy of the National Banking Act is to secure equality of treatment to the creditors of an insolvent bank and there is no such thing as a 'preferred claim' under the statute. 12 USCA 194. Those entitled to trust funds held by the bank may enforce the trust against the receiver, not on the ground that the law gives them a preferred status but that the receiver has property which in equity and good conscience belongs to them. But unless they can trace the trust funds into some fund or specific property which has come into his hands or can show that the assets in his hands have been directly augmented as a result of the conversion of the trust funds by the bank, they have no basis upon which relief can be granted them."

(Citing Cases)

It has been clearly shown that the claimant has not established that property belonging to him came into the estate and is traceable into the hands of the trustee in bankruptcy in its original or substituted form. That being the case, the claim to be entitled to priority of payment therefore must come within the provisions of Section 64 of the Bankruptcy Act, particularly Section 64 (b) 5 thereof, which is as follows:

> "The debts to have priority in advance of the payment of dividends to creditors and to be paid in full out of bankrupt estates, and the order of payment shall be (5) wages due to workmen, clerks, traveling or city salesmen, or servants, which have been earned within three months before the commencement of the proceeding, not to exceed $600.00 to each claimant."

Thus, Congress has limited the claims of the employes in bankruptcy proceedings. However, it is to be noted that the claim filed by Maurice Paradise, as Trustee is not predicated upon wages, and the proceedings before the Referee, the District Judge and the Circuit Court of Appeals were not conducted upon the wage claim theory. Congress never intended the claims of employees to be treated on a different basis than claims of other persons, except to the extent provided for in said Section 64 (b) 5. Section 17 (a) 6 of the Bankruptcy Act provides in effect that a discharge in bankruptcy shall release a bankrupt from all of his provable debts except such as are "(6) Due for moneys of an employee received or retained by his employer to secure the faithful performance by such employee of the terms of contract of employment" it is significant of the intention of Congress in this respect that while such claims are exempted from the effect of a discharge, Congress did not see fit to grant priority of payment for same.

2. The effect of the decision of the court below is to allow a claim in a bankruptcy proceeding which clearly did not come within the classification of claims entitled to priority

as established by Section 64 (b) of the Bankruptcy Act as amended. The claim also could not be sustained upon the theory of reclamation of property belonging to the claimant, therefore the decision must be said to rest upon general principles of equity jurisprudence.

In the case of *Burton Coal Co.* v *Franklin Coal Co.*, 67 F. 2d 796 (CCA 8) the court held as follows (page 797):

> "Some question is raised as to the equity jurisdiction of the Bankruptcy Court. That it is a court of equity in the sense that its judges and referees in adjudging the rights of parties entitled to their decision are governed by principles and rules of equity jurisprudence is beyond question."
>
> (Citing Cases)
>
> "It has not, however, plenary jurisdiction in equity but is confined in the application of the rules and principles of equity to the jurisdiction conferred upon it by the provisions of the Bankruptcy Act reasonably interpreted."
>
> (Citing Cases)
>
> "The plain mandate of the law cannot be set aside because of considerations which may appeal to the Referee or Judge as falling within general principles of equity jurisprudence."

In the case of *Southern Bell Telephone & Telegraph Company* v. *R. B. Caldwell*, 67 F. 2d 802 (CCA 8) the claimant sought priority of payment on equitable grounds. The referee in passing on the question held that Section 64 (b) is exclusive as to classes of debts which are entitled to priority of payment in advance of payment of dividends to creditors and that the petitioner's claim did not fall within any of the classes as set forth in said section. The Circuit Court of Appeals in said case sustained the contention of the Referee, citing with approval its former decision in the case of *Burton Coal Co.* v. *Franklin Coal Co.*, 67 F. 2d 796 (CCA 8).

The court below has not cited a single case which is contrary to the principles enunciated in the cases cited in this

brief. The case of *Jennings* v. *U. S. F. & G. Co., supra* has been heretofore distinguished, and in fact sustains the propositions urged herein. The case of *Standard Oil Co. of Ky.* v. *Hawkins,* 74 F. 397 (CCA 7) is not in point. In this case the claimant could trace funds belonging to him in the hands of a receiver of a bank, but prior to claimant making a claim to said funds, the receiver had disbursed the same to general creditors, and the court merely held that the claim of the claimant was not defeated thereby since the other assets in the hands of the receiver were sufficient to discharge the claim. Reading from the opinion (page 399):

> "The receiver is a trustee holding these funds for distribution among the creditors of the bank according to their respective rights. He is an officer of the law. Equity will not permit a trustee to avail himself as against a cestui que trust of a mistake of law on the part of the latter when it is possible to correct the error without injury to the trust estate. Here it is true the specific money of the appellant is no longer in the hands of the receiver. It has been distributed by him in the proper discharge of his duty among the creditors; but as the property of the appellant was erroneously, although through no fault of the receiver appropriated to the benefit of the general creditors, there is no injustice in a restoration, if assets remain out of which indemnification can be had. The general creditor will receive not a penny less than is his due. The appellant if the remaining assets prove sufficient and availing will receive that to which it is entitled and no more."

The case of *Gorman* v. *Littlefield,* 229 U. S. 19 is a stock brokerage case and is not in point. In said case for a year or more before the failure of the stock brokerage house, claimant was a customer dealing with one of its Chicago offices, buying stocks on margin and also paying for them in full. The claimant directed the Chicago office to buy 250 shares of Green Cananea Copper stock for him. The stock

was bought on the understanding that it was to be paid for in full and at the time the order was executed the claimant had an ample credit balance with the firm applicable on its books to the payment in full of the shares purchased. The certificates of stock were left by the claimant in the possession of the broker, subject to claimant's further order. The stock was purchased and certificates received for same by the broker. The actual certificates of stock were later hypothecated in various manners by the broker. At the time of the petition in bankruptcy, the receiver in bankruptcy and then the trustee came into possession of certificates endorsed in blank for an aggregate of 350 shares of Green Cananea Copper Stock. As to this stock no claim had been filed with the receiver or the trustee, although the time for filing claims had expired. This court, therefore, held that the certificates of stock were not the property itself, but merely the evidence of it and that a certificate for the same number of shares represented precisely the same kind and value of property as a certificate for a like number of shares in the same corporation; that the substitution of one share for another made no material change in the property right of the customer and that a stock broker when selling shares of stock purchased by him for third persons is obligated to buy others of like kind and keep same on hand, subject to the order of the customer. There being no other claimants for said certificates, the claimant was entitled to receive the 250 shares out of the 350 shares on hand at the time of bankruptcy.

The case of *Knatchbull* v. *Hallett*, 13 Ch. Div. 696 is not in point, since in said case by the terms of a marriage settlement the sum of 2300 pounds was actually placed in the hands of trustees. Several changes were made in the investment of the fund, the fund being first invested in a mortgage which was later paid off and then invested in Russian 5 per cent Bonds. The Russian Bonds were subsequently sold by Hallett, who came into possession of the

fund, and the proceeds deposited by him in his bank account. It, therefore, appears that a fund created by the payment of money to trustees in trust was created, which was subsequently traced into the bank account of Hallett. The doctrine of this case was, therefore, a question of tracing a trust *res* and the consideration of the question as to whether the commingling of the fund in the bank account of the trustee destroyed the right of the *cestui que* to follow and reclaim the same.

The Circuit Court of Apeals has not cited a single case, nor has the respondent all through these proceedings, where a claimant has been allowed priority of payment in a bankruptcy proceeding, or in any other insolvency proceeding, where the only claim of the creation of a fund has been in the shifting of debits and credits on the books of an insolvent.

VII.

Where the Findings of a Referee Are a Deduction From Established Facts, or Uncontradicted Evidence, the Judge is at Liberty to Draw His Own Inferences and Deduce His Own Conclusions.

The findings of the referee quoted by the court below were not binding upon the district judge or the Appellate Courts. The findings of fact and conclusions of law made by the distinguished referee were based upon a stipulation of facts and undisputed testimony and it is sometimes stated that findings by a referee are presumptively correct and will not be disturbed unless they are clearly against the weight of evidence or some obvious error of law has intervened in its application. However, this rule does not apply to inferences to be drawn from admitted facts.

In the case of *In re Solof*, 2 F. 2d 130-132 the Circuit Court of Appeals for the Ninth Circuit held as follows:

> "No doubt, findings by a referee in bankruptcy are presumptively correct and will not be disturbed unless

they are clearly against the weight of evidence or some obvious error of law has intervened in its application. This rule, however, has little application to inferences to be drawn from admitted facts. In the present case if every controverted question of fact was resolved in favor of the trustee, the question still remained—Was a preference intended? and the court was fully as competent to determine that question as was the Referee and had the same opportunities. In the case of Ohio Valley Bank Co. v. Mack 163 F. 155, is the following opinion: 'Much in both cases must depend upon the character of the finding. If it be a deduction from established fact, the finding would not carry any great weight for the judge having the same facts may as well draw inferences or deduce a conclusion as a referee.'"

In the case of *In re Sullivan Condensed Milk Co.*, 291 F. 66-68 (CCA 7), the court held as follows:

> "This is not a case where the court saw and heard the witnesses whose testimony is conflicting. It is a case where the facts are stipulated and we are to make deductions from the stipulated facts. The findings of the referee are, therefore, entitled to no more weight than the stipulated facts warrant."

The court below in its opinion says as follows (R. 36):

> "The employees did not know whether the money had been turned over to the Welfare Association or not. The Welfare Association did not know how much had been deducted from the employees' wages. It is elementary that no waiver of rights or ratification of wrongful actions can occur without knowledge of the facts."

This is a mere assumption on the part of the court below and there is nothing in the record from which this conclusion could be drawn. The stipulation of facts clearly showed that the Welfare Association was governed by its own officers and directorate and maintained its own account in The First National Bank of Chicago (R. 10). It also showed that commencing with February 4, 1933 the

bankrupt began to fall in arrears, which continued until November 24, 1933; that during said time the officers of the Welfare Association had made demands upon the bankrupt for payment of the amount due it but that no action was taken by the Welfare Association or its successors until the bankrupt was placed in equity receivership and a claim filed by Maurice Paradise, as trustee therein. It would, therefore, follow that the employees through their own officers in the association had knowledge of the entire situation and in the absence of a showing of any protest acquiesced in the manner in which the transaction in question was handled.

CONCLUSION.

We have previously called attention to the fact that the primary purpose of the Bankruptcy Act is to provide for equality of distribution among the creditors and to prevent preferences. Therefore, those charged with the duty of administering a bankruptcy estate must look first to the Bankruptcy Act when determining the classes of claims which are entitled to priority of payment. If a claim does not come within any of the classifications of Section 64 (b) of the Bankruptcy Act, the sole question presented is whether any property belonging to third persons, or the proceeds of such property, came into the hands of the trustee. In such a case a claimant sustaining the burden of identifying his property, or the proceeds thereof, is entitled to reclaim his property. The court's attention is called to the fact that the trustee in bankruptcy no longer stands in the shoes of the bankrupt with respect to property of the bankrupt coming into his custody, but is also vested with all of the rights, remedies and powers of a creditor holding a lien by legal or equitable proceedings thereon. (Section 47 (a) 2.) It would indeed be a dangerous precedent for courts to resort to legal fictions in order to grant priority to claims not otherwise granted priority of pay-

ment by the Bankruptcy Act and so far as the other general creditors of an estate are concerned, it would be manifestly unfair to them since they obviously can have only such rights in a bankruptcy estate as the Bankruptcy Law provides.

The decision of the court below is erroneous and should be reversed.

Respectfully submitted,

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